Private Power Practitioners—Viva Las Vegas!

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The current debates regarding the limits on the scope of electric utility and convergence mergers, and the extent of regulation of power product commodities, are not just about the nice details of retail access—they are about the essence of the future business. Private power needs to focus on their profound risk management aspects: that focus will enable it both to take tactically useful policy positions and to develop an appropriate business plan. To win—or to be cast aside.

THE EVOLUTION OF RISK

When PURPA was a pup, the last risks a power privateer saw were the avoided cost price zinging into the contract; the long term fuel contract lock into place (at a price below the power price) and the air quality permit slapped on the side of the old QF. Now the business is all about risk management—mitigating the risks of price movements through financial or physical hedges.

Without doing that, a utility or a power privateer has problems knowing how and when to buy or market his newly commoditized product. Shareholders and bondholders of his company and projects will ultimately figure that out. As retail access becomes more generally available, so too will customers. The result for power privateers: exposures to power-fuel price disparities; competitor risk; even risk as to payment. To date, for example, COB power prices have been far more volatile than those of any conventional fuel.

Consequently, of course, has come the entrance of the private power risk management tools: forward fixed price contracts; traded

future contracts; off exchange swap contracts; options; and now insurance programs (which are really synthetic sales transactions reflecting someone else's presumably more expert management of risk than that of the mere producer in the trenches.)

What this unavoidable trend implicitly means is that the same power firm is a "book" company in the energy business; a "virtual" company with small but definite market bet exposure and potentially larger still unhedged exposure; and a "tax" company whose results depend on the market and the treatment of its hedging and insurance arrangements. While every business is a portfolio of strategic decisions it has undertaken, power companies are now or soon will be—to a greater extent than manufacturing firms—best understood as a portfolio of the market risks they take; the quality of the people they have taking them; and the "goods" they have to back them up.

RISK TOMORROW

All of this may be a yawn to you, but now the stakes are going up even farther for power producers at the Electric Casino because now "the House" (risk management industry) is willing to accept power producer's first born (under utilized assets; blocks of future capacity) as the chips paid to the House for risk coverage bets. It is all a matter of swapping "utilization of inefficient assets," i.e. call on generator production in exchange for firm price protection for future generator power delivery.

The possibility of interfuel energy swaps—for production capability or for profit—adds another dimension to possible deals. To put it differently, the power company is the grain producer; the insurance company is both the grain elevator and the trading pit manager. It may be good business for the power producer, but only if managed very carefully. It adds yet a new aspect to corporate risk valuation.

In this new world, the real "independent power player" is the risk counterparty. Washington has not, cannot or will not wake up to all of this. What needs to be examined by regulators when, for example, they are examining corporate combinations, is whether their rather quaint economist tools for measuring "market power" and equally conceptualistic tools for its "mitigation" are really addressing the ways in which the real power commodity markets can be played

by large traders in transmission constrained regions. In short, in the new electric casino, can "convergence" simply be judged by horizontal merger standards?

SOME MODEST SUGGESTIONS

The other obvious conclusion is the need for changes in our approach to electric public policy. It is time for Steve Wynn of Golden Nugget for FERC Chairman, Dwayne Andreas for Secretary of Energy; Las Vegas and Hartford as the twin capitals of the gambling/insurance energy world. The AICPA must develop, in conjunction with the Kennedy School, a new FERC Uniform System of Contingent Accounts. The Salomon Brothers will offer continuing enactments of it at Caesar's Palace.

Private power is no longer about bucking the old system. It is about beating the new system. Public policy is about learning to be happy with the new system. Viva Las Vegas!

ABOUT THE AUTHOR

Roger D. Feldman is co-chairman of the 40-person Project Structured Finance Group of the 250+ attorney firm of Bingham & Dana, based in Washington, DC. He has represented the Power Marketers Association and individual power marketers, and also has represented power purchasing trade associations and aggregators. He is Washington editor of *The Cogeneration and Power Marketing Letter* and *of The Construction Business Review* and is on the Editorial Board of *Cogeneration and Competitive Power Journal*. In his more than 25 years of practice, he has participated in the closing of over $8 billion in transactions.